A Futuristic Lesson In Old And New

by Steve Brown

We have long been fans of the Star Wars movies and we are pretty excited that there is a new one in the making due to be released in December, 2015. Han Solo, Princess Leia, and Luke Skywalker are all taking part, plus there has been buzz about some new actors in the mix. In addition to new people, the producers have also released a photo of a fantastic new animal. It is a pig-like creature complete with a be-whiskered snout and boar tusks, but this guy is the size of a garbage truck and has big stubby legs like a rhinoceros. We've always appreciated that Star Wars brought Dr. Seuss-type animals to life on-screen and we wait eagerly to find out if the big pig is helpful or harmful to the Jedi.

Speaking of a combination of old and new, many banks are reviewing and revising their policies and procedures in light of growing expectations for an increase in interest rates. Banks have concentrated (appropriately) on the impact rising rates will have on the loan portfolio and deposits with a focus on managing changes that are likely to occur with higher rates. One other area that has grown in most banks over the past few years and therefore deserves attention is the securities portfolio, because it too can damage a bank's capital as rates rise.

Most bank investment portfolios hold a significant quantity of mortgage-backed securities (MBS). As long as interest rates have declined, there has been refinance activity in the underlying home loans and this has flowed through to MBS, creating cash flow beyond the level that ordinary buying and selling of homes would support. This is not a new phenomenon as mortgage rates have been dropping for more than 30Ys. In fact, they hit their highest point in 1981 at an average annual rate of 16.63% and since then have generally declined. At this point, mortgage rates seem unlikely to go lower than the last 2Ys and we are already seeing a significant drop in refinancing activity. This has slowed the cash flow of MBS securities and major extension of the duration and life of these types of securities is likely.

By policy, banks look at yield tables and pre-purchase packages in order to assess extension and prepayment risk on these kinds of securities. The problem is that all of the analytics and tables used to calculate these speeds are based on history, dominated by the activity of the last 30Ys. No one knows what could happen once rates rise from historic lows, so further analysis is critically important.

For their part, investment policies usually specify an average life or average duration that is considered acceptable in light of managing interest rate risk in the portfolio. Average life and duration should also be shown with various levels of stress, but if the calculations to arrive at these figures are based on assumptions from the last 30Ys of history, the level of extension in these securities could be far more.

Many banks are willing to take more risk in their loan portfolios than in their securities portfolio. This is especially true of credit risk, but generally for interest rate risk as well. As your bank considers investments going forward, be sure your policy takes into consideration that the behavior of MBS securities may be different in the future than it was in the past, so the underlying models also have built-in risk that may not be easily measured. Also, it would be a good idea to run some analysis considering the possibility of very long extension in the MBS your bank currently holds.

Hopefully, your bank's investment policy doesn't turn out to be a big inter-galactic animal with characteristics of unknown origin and usefulness. By keeping in mind both the old and the new when revising your policy periodically, your portfolio can help your bank avoid risk and generate return now and into the future.

BANK NEWS

Tough Times

Research by Yale University finds students that entered the job market in 2010 and 2011 earned 19% less than what they could have expected without the recession. The National Center for Education Statistics reports that during this period salaries for bachelor's degree-or-higher grads fell 6% to $49,950 (vs. $52,990 in 2007).

Slipping Further

Bloomberg reports trading in U.S. government bonds has tanked 25% in the past few weeks compared to the same period last year as corporate debt sales decline and investors view the global economy as still in flux, so are content to wait it out.

Home Buying

Census data finds 12% fewer households under age 35 owned a home as of Q1 than when compared to Q1 of 2008 (36.2% vs. 41.3%).

Spotty Lending

A National Federation of Independent Business (NFIB) survey finds only 2% of small business owners indicate getting financing is their biggest current issue.

Improving Quality

The Financial Times reports bank credit quality for the largest U.S. banks improved to the best level in 8Ys in Q2.

Fixed TDR

A recent Fed publication reminds bankers that troubled debt restructures (TDRs) can be removed from that designation for regulatory reporting but always remain so designated under accounting rules. Under regulatory reporting, if the TDR borrower has complied with the modified loan terms and the loan yields at least a market interest rate it no longer has to be reported as a TDR on the Call Report in calendar years following the year in which it was restructured.

More Time

Community banks trying to figure out what to do with their aging customer base and how to capture younger customers will be interested to know you may have more time to figure it all out. The latest data from the Society of Actuaries has extended the lifespan of a 65Y old to 88Ys.